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401372—41

In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 191

ROESER & PENDLETON, INC., PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the United States Board of Tax Appeals (R. 95–105) is not reported. The opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 137–140) is reported in 118 F. (2d) 462.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 21, 1941 (R. 140–141). The petition for a writ of certiorari was filed June 19, 1941. The jurisdiction of this Court is invoked

under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Petitioner transferred certain oil leases in consideration of $400,000 in cash and the reservation of a specified fraction of the oil in place until it should realize an additional $1,200,000 from the production of oil out of the reserved interest. Is petitioner entitled to the statutory 27½% depletion allowance with respect to any part of the $400,000 cash payment?

STATUTE INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

> SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.
>
> * * * * *
>
> (b) *Basis for Depletion.*—
>
> (1) *General Rule.*—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.
>
> * * * * *
>
> (3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year,

excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

STATEMENT

In 1931, petitioner, a Delaware corporation, purchased an undivided one-half interest in 10 oil, gas, and mineral leases, and an undivided one-fourth interest in an additional lease, making 11 leases in all, covering lands in Gregg and Upshur Counties, Texas, in what is known as the East Texas Oil Field. On May 13, 1936, petitioner entered into a contract with R. G. Trippett and A. H. Meadows to sell to them, for a total of $400,000 in cash, its undivided interests in the 11 oil, gas, and mineral leases, and all of its interest in the equipment and personal property situated on the property. By the terms of the contract, however, the petitioner reserved title to one-fourth of seven-eighths of the oil, gas, and minerals in place, and produced and saved from 10 of the leases, until it realized from the sale of oil and gas produced from the reserved one-fourth interest, at the then current market price, a total of $1,130,000; and, with respect to the eleventh lease, petitioner reserved the title to one-

eighth of seven-eighths of the oil, gas, and minerals in place, and produced and saved from the eleventh lease, until it realized from the sale, of oil and gas produced from the reserved one-eighth interest, at the then current market price, the sum of $70,000. Following the receipt by the petitioner of the $1,130,000 plus $70,000 (totaling $1,200,000) from the oil and gas produced from the reserved interests in the 11 leases, the title to the reserved interest was to vest in the purchasers (R. 97–98).

Trippett and Meadows assigned all of their rights under the May 13, 1936, contract to J. K. Wadley, who, in turn, assigned his interest to Atlantic Oil Producing Company (R. 100).

The transaction between petitioner and the Atlantic Oil Producing Company was consummated in accordance with the terms of the agreement. Petitioner received from Atlantic Oil Producing Company the $400,000 in cash, as provided therein, and, from the effective date of the transaction, May 30, 1936, up to and including December 31, 1936, petitioner received from the "reserved interest" provided in the agreement the sum of $69,301.30, less $1,643.09 production taxes, or the net sum of $67,658.21. This amount was paid directly to it by the Pipe Line Company which ran and produced the oil and gas from the properties, pursuant to and in accordance with division orders executed by petitioner. (R. 100–101.)

In its 1936 income tax return, petitioner claimed as a deduction from gross income a depletion allow-

ance of 27½% on the entire $400,000 cash received from the Atlantic Oil Producing Company. It also claimed, on its return, depletion at the rate of 27½% on the gross amount of $69,301.30 received from the "reserved interest." The Commissioner disallowed any depletion deduction on the $400,000 cash payment but allowed percentage depletion on the $69,301.30 sum received by it from the oil produced (R. 101).

On appeal to the Board of Tax Appeals it was stipulated (R. 40) that the undepreciated and undepleted cost of the personal property included in the transfer was $187,418.23. The petitioner chose to treat part of the $400,000 cash payment as a return of this cost, and conceded that its claim for the 27½% allowance for depletion, if valid at all, was applicable only to the remaining $212,581.77 (R. 102). The Board of Tax Appeals concluded that the petitioner was not entitled to the depletion allowance with respect to any part of the $400,000 payment (R. 102). The Circuit Court of Appeals affirmed the decision of the Board as to this issue (R. 137–140).

ARGUMENT

The depletion deduction from "gross income from the property" permitted by the statute is a deduction from gross income realized from the production of oil on the property; it is not a deduction from income realized from the sale of the property. *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372, 375–376; *Ortiz Oil Company* v. *Com-*

missioner, 102 F. (2d) 508 (C. C. A. 5th), certiorari denied, 308 U. S. 566; *Darby-Lynde Co.* v. *Alexander,* 51 F. (2d) 56, 59 (C. C. A. 10th), certiorari denied, 284 U. S. 666. The variety which marks agreements for the transfer of interests in oil-producing property consequently creates a necessity for determining in each case whether the income received by the transferor as a result of the agreement is income arising from the production of oil or from the sale of the property.

In *Anderson* v. *Helvering,* 310 U. S. 404, 408–409, this Court identified the two categories in which particular transactions must be placed. It was observed that the owner and operator of oil properties "clearly has a capital investment in the oil in place, if anyone has, and so is taxable on the gross proceeds of production and is granted a deduction from gross income as compensation for the consumption of his capital." Such an owner can, however, sell his interests outright, thus converting his capital investment into cash, severing his connection with the production of oil and gas, and rendering "inapplicable to his situation the reasons for the depletion allowance."

To the extent that owners [1] have devised methods of transfer by which they are enabled to sell

[1] For purposes of the issue raised by this case, the holder of a lease entitling him to conduct operations and to receive a substantial part of the proceeds from production may be treated as an owner. See *Lynch* v. *Alworth-Stephens Co.,* 267 U. S. 364, 369; *Palmer* v. *Bender,* 287 U. S. 551, 558.

a part of their interest while retaining another part, they have created situations which, "falling between the two mentioned, have been put on one side or the other as the case arose."

In its classification of these situations to date, this Court has determined that income which the seller obtains from royalties paid out of sums realized from the production of oil represents income from a retained capital investment and is consequently subject to the allowance for depletion. *Palmer* v. *Bender,* 287 U. S. 551; *Murphy Oil Company* v. *Burnet,* 287 U. S. 299; *Burnet* v. *Harmel,* 287 U. S. 103. Where title to a specified fraction of the oil is reserved by the seller until a named sum is realized from its production and sale, the income which he receives from it is treated in the same manner as royalties, for purposes of depletion allowances. *Thomas* v. *Perkins,* 301 U. S. 655, 663. On the other hand, periodic payments of stipulated sums, combined with an agreement for profit-sharing to commence at a later date, even though the buyer is free to discontinue the payments if the productivity of the wells proves unsatisfactory, do not constitute income from a retained economic interest or capital investment entitling the seller to depletion allowance. *Helvering* v. *Elbe Oil Land Company,* 303 U. S. 372.

Where an agreement provides for a cash payment at the date of transfer, as well as for future royalties or payments to the transferor from the proceeds of a designated fraction of the oil pro-

duced, the critical question is whether the cash payment is to be treated as an "advance royalty" or "bonus", or as consideration for an outright and immediate sale *pro tanto* of the transferor's interest. This question has received varying answers by the courts, depending upon the character of the transfer agreement involved. In *Commissioner* v. *Fleming*, 82 F. (2d) 324 (C. C. A. 5th), the agreement contemplated that the transferor would receive an immediate cash payment, plus the proceeds from the production and sale of half the oil transferred until these proceeds reached a named total. The Circuit Court distinguished between these two sources of income, holding that the former arose from the sale of a capital asset and was not subject to a depletion allowance, while the latter arose from the operation of the oil wells and was subject to the allowance.

The Circuit Court of Appeals in the instant case correctly considered its decision in the *Fleming* case as controlling. There is no doubt that the agreement here reserved to the petitioner an "economic interest" in one-quarter of seven-eighths of the oil in place (which was one-half of the total interest transferred)[2] nor that the income up to $1,200,000 which he receives from the sale of that fraction of the oil is subject to the allowance for depletion. *Thomas*

[2] Except in the case of the eleventh lease, where one-quarter of seven-eighths was involved in the transfer, and petitioner reserved title to one-eighth. See pp. 3-4, *supra*.

v. *Perkins*, 301 U. S. 655. The only contest concerns the treatment of the $400,000 cash payment. It is conceded that $187,418.23 of this amount is not subject to the allowance because it represents a return to the petitioner of the cost of the personal property attached to the leaseholds. And the remaining $212,581.77 must also be treated as consideration for the sale of a capital asset, namely, the remaining one-fourth of seven-eighths of the oil in place included in the transfer, title to which was not reserved by the petitioner. Unless it is so regarded, no consideration for this quarter-interest can be found in the agreement. Nor can it be fairly construed as a "bonus" or advance payment of the contemplated receipts from the sale of the quarter-interest to which title was reserved. Cf. *Palmer* v. *Bender*, 287 U. S. 551. It is significant that not until the time of the proceedings before the Board of Tax Appeals did the petitioner indicate what portion of the $400,000 it regarded as constituting the "bonus" (R. 102). It would require an extremely strained construction to conclude that the parties to the transfer agreement *intended* that the petitioner should immediately receive $212,581.77 as an "advance royalty" or "bonus", in contemplation of future production.

The agreement therefore must be construed as providing that title to one-half the oil in place and to the personal property attached to the leaseholds should be sold outright for $400,000. The

petitioner is not entitled to the 27½% allowance for depletion as to any part of this $400,000, since it represents the consideration for the sale of a capital asset. *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372, 375–376. It is immaterial that an "economic interest" was concededly retained in the other quarter-interest transferred and that the petitioner is entitled to an allowance for depletion with respect to the proceeds realized from the sale of the oil to which title was thus reserved.

The petitioner urges as a reason for granting the writ that the decision of the Circuit Court of Appeals, together with its earlier decisions in *Commissioner* v. *Fleming*, 82 F. (2d) 324 and *Laird* v. *Commissioner*, 97 F. (2d) 730, is in conflict: (a) with the opinion of this Court in *Palmer* v. *Bender*, *supra;* (b) with the opinion of the Circuit Court of Appeals for the Ninth Circuit in *Elbe Oil Land Co.* v. *Commissioner*, 91 F. (2d) 127, reversed 303 U. S. 372; and (c) with the decision of the United States Court of Claims in *Heep Oil Corporation* v. *United States*, 32 F. Supp. 762. We submit that these contentions are unsound.

1. *Palmer* v. *Bender*, *supra*, involved a transfer of a portion of a leasehold in consideration, *inter alia*, of a royalty chargeable against a percentage of the oil to be produced out of the entire portion of the property transferred together with an advance bonus. Here on the other hand, petitioner

created two entirely separate interests in the property; it sold one for a fixed amount, and retained an interest in the other. Obviously, the purchase price of the interest sold could not be subject to a depletion allowance, notwithstanding the applicability of the allowance to the periodic payments to be received out of the oil produced.

2. In *Elbe Oil Land Company* v. *Helvering,* 91 F. (2d) 127 (C. C. A. 9th), the transfer agreement provided: (a) that the buyer pay $350,000 in cash in 1927; (b) that it pay $400,000 in cash in each of the years 1928, 1929, and 1930; (c) that it pay $450,000 in 1931; (d) but that it might elect to abandon the purchase prior to the 1928 payment, and again, prior to the 1929 payment; (e) that after 1931, the buyer receive all the income from the property until it should be reimbursed for all its previous expenses, including the prior cash payments to the seller, totaling $2,000,000; (f) that thereafter the seller would receive one-third of the net profits resulting from production and operation. The initial $350,000 payment in 1927 exceeded the cost of the property transferred, and the seller reported the difference as taxable income. In 1928 and 1929 it claimed the 27½ percent allowance for depletion with respect to each of the $400,000 payments.

The Circuit Court of Appeals for the Ninth Circuit held that the claim was a valid one, de-

claring that the payments were indistinguishable from "bonus payments and royalties." The court regarded it as significant that until 1929 the buyer could elect to discontinue the payments, that it would continue to make them "only because of the belief that development of the oil resources of the land justified such payment," that "the whole contract was based upon the value of the oil content of the land," and that as a consequence the seller "had at all times an economic interest in the oil produced from the leased premises" (91 F. (2d) 127, at 128, 130). To the contention that *Commissioner* v. *Fleming* (82 F. (2d) 324 (C. C. A. 5th)), upon which the Circuit Court of Appeals for the Fifth Circuit relied in the instant case, required a different result, the court replied:

> If the case at bar cannot be distinguished from [*Commissioner* v. *Fleming*] * * * because of the fact that the two $400,000 payments involved here were to be optional with the purchaser, and thus were obviously dependent upon the result of exploratory operations for oil, and because of the fact that the vendee had the right to surrender the premises at any time before the payment of the second $400,000, as the Commissioner contends that it can be distinguished, we must decline to follow that decision". (91 F. (2d) 127, at 130)

Certiorari was granted by this Court because of the asserted conflict with the *Fleming* case (303 U. S. 372, 374), and the judgment was reversed on the ground that the contract "provided for an absolute sale of all the properties in question * * * and that [the seller] did not retain any interest or investment therein", and that "neither the cash payments nor the agreement for a share of the subsequent profits constituted an advance royalty, or a 'bonus' in the nature of an advance royalty" (303 U. S. at 375).

Petitioner contends that the asserted conflict between the decision of the Circuit Court of Appeals for the Ninth Circuit and the *Fleming* case was not resolved by the opinion of this Court (Pet. 3, 15). It urges that this Court simply differed with the Ninth Circuit in its appraisal of the facts of the case, but left unaffected the rule of law enunciated by the intermediate court. And since the situation in the instant case is strictly analogous to that involved in the *Fleming* case, petitioner contends that the writ should be granted here for the purpose of settling the conflict between the two rules.

We think the petitioner has misunderstood the import of this Court's decision in the *Elbe* case. The judgment of the Circuit Court was not reversed because of a disagreement over what the record showed. It was reversed because, in the

view of this Court, the two $400,000 payments in 1928 and 1929 did not represent advance royalties or bonuses. That is to say, they did not represent income from an interest reserved by the seller in any part of the oil to be produced. Not only did the rule of law embodied in this conclusion resolve any conflict between the *Fleming* case and the decision of the Circuit Court in the *Elbe* case in favor of the former; it provided the rule applicable to the instant case. For the question here as there is whether the cash payments represent income from an interest reserved by the seller, or whether they represent a *pro tanto* conversion of capital investment from oil to money.

3. The petitioner further asserts (Pet. 2, 13) that the decision below is in conflict with *Heep Oil Corp.* v. *United States,* 32 F. Supp. 762 (Ct. Cl.). In that case, the taxpayer sold producing oil property for $106,000 plus an additional sum to be paid out of one-half of the proceeds of oil or gas produced. In the year of the sale, 1930, this fraction of the proceeds amounted to $46,947.28. The taxpayer claimed and was allowed a deduction of $78,412.63, which represented the full cost of the leases and equipment disposed of. It later sought an allowance for depletion with respect to the $46,947.28. In dismissing the suit, the Court of Claims specifically stated that (p. 766):

> We do not decide whether or not plaintiff is entitled to depletion. We hold only that it is not entitled under the instrument in this case to deduct both the cost to it of the property and depletion also.

The court then proceeded to point out, purely by way of *dictum,* that if a depletable oil interest were retained, the depletion must be computed with respect to the entire amount paid and not merely as to the deferred payments to be made out of proceeds from the oil produced. It is obvious that the decision was limited to the holding that there was no overpayment of tax. Thus, the decision was in the Government's favor. Accordingly, petitioner's criticism here (Pet. 14) of the Government's failure to apply for certiorari in the *Heep* case is without merit.

It may be added that whatever significance might otherwise attach to this dictum in the *Heep* case, is virtually eliminated by the squarely contradictory holding by the same court in *Berry Oil Co.* v. *United States,* 25 F. Supp. 97, certiorari denied, 307 U. S. 634.

CONCLUSION

The case raises no new questions of general importance but involves merely the application to its peculiar facts of principles recently settled by this Court. The decision of the court below is correct.

There is no conflict of decisions. The petition should be denied.

Respectfully submitted,

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